Investment update

14 January 2010

Stephen Snowden, manager of the Old Mutual Corporate Bond Fund

Stephen Snowden is a highly experienced fund manager who has specialised in corporate bonds for the last ten years. Earlier in his career he focused on equities, which gave him a strong grounding in company analysis, which is at the cornerstone of his investment process. Stephen combines top down analysis with bottom up stock selection, believing that selecting good bonds, rather than good companies, is the key to delivering returns for investors.

Stephen Snowden joined OMAM in 2004 and is the manager of the Old Mutual Corporate Bond Fund, as well as the bond element of the Old Mutual Extra Income Fund. He was previously Head of Retail Fixed Income at Aegon Asset Management where he managed the Aegon Extra Income Fund.

'Coulrophobia'

By Stephen Snowden, manager of the Old Mutual Corporate Bond Fund

When Lloyds announced its £13 billion rights issue in November last year, it also offered to exchange £7 billion of existing subordinated Lloyds TSB, Bank of Scotland and HBOS bonds into new Enhanced Capital Notes (ECNs). These ECNs are contingent convertible bonds, which effectively work as convertible bonds in reverse – changing from a coupon-bearing bond into common equity when the share price is weak. Contingent convertibles were quickly abbreviated to CoCos, leading to the obvious association with clowns.

Only time will tell if people who bought CoCos will end up looking like clowns, but after two months of trading the signs for CoCos to do well are promising. When the CoCos first emerged from the exchange process they traded with yields of more than 11%, whereas many are now trading at around 9%, representing a substantial rise in price.

I said back in November that we would apply to exchange our existing holdings into CoCos and we were lucky enough to have some of our bonds exchanged. One of the arguments I made was that banking capital requirements were going to increase. Simply put, bank balance sheets would be required by law to be stronger. In proposals from Basel on 17 December 2009, a document titled "Strengthening the Resilience of the Banking Sector" spelt out that the quality and quantum of capital for banks would have to increase. The latter was not quantified, but the former was. It noted that the predominant form of Tier 1 capital should be equity and retained earnings (core Tier 1). It is reasonable to assume that when the consultation period is over, core capital requirements will be significantly higher than is currently the case. The current minimum capital requirement is a Tier 1 ratio of 4%, but most banks and investors really see a core Tier 1 ratio of 8% as the modern minimum.

CoCos only convert from bonds to equity if the core capital ratio of Lloyds falls below 5% and there is a chance that regulation may dictate a minimum core capital ratio of higher than this, with 6% or above not unrealistic. In that scenario, Lloyds would not be allowed by law to ever be in a position to convert CoCos from bonds to equities. In that scenario the CoCos would be bullet maturity (i.e. non-callable), must-pay Lower Tier 2 bonds. Bonds of that description trade at materially lower yields, therefore in this blue-sky scenario CoCos would enjoy a material capital appreciation.

Lloyds Banking Group clearly has many challenges ahead, with considerable bad debts to contend with for several years. However, the bank has a pre-provision capacity to earn over £10 billion a year and that, combined with a core Tier 1 ratio in excess of 8%, means that the chance of conversion into equity is remote.

Coulrophobia is an irrational fear of clowns. I see the concerns surrounding CoCo bonds as being overstated. With potential material upside, the market is coming round to the concept of these bonds, hence their impressive performance since launch.

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